PRIVATE PASSENGER AUTO INSURANCE ANALYSIS OF RATE LEVELS AND TERRITORY DEFINITIONS

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FOR THE ATTORNEY GENERAL OF THE STATE OF CONNECTICUT

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Private Passenger Auto Insurance
Analysis of Rate levels and territory Determinations

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Executive Summary

Automobile rate levels in Connecticut are excessive. Individuals with good driving records who live in Connecticut's largest cities have particular problems with excessive prices. Rates for all Connecticut drivers should be reduced by 5.9% to 15%; for city dwellers with good driving records there may be significant opportunities to reduce auto insurance premiums even further. There is considerable evidence that private passenger auto insurance rates are too high in Connecticut. Based on well-recognized insurance industry criteria, insurance company profits from policies written for Connecticut drivers in 1996 and 1997 were very high. Connecticut consumers provided auto insurers with the fifth highest profit margin in the country in 1996; 40% higher than the national average return.
High profitability appears to continue in 1998. However, consumers have seen rates fall by only 1.2 percent in 1998, compared with needed estimated reductions of at least 5.9% and as much as 15%.

The insurance companies that serve Connecticut currently hold the full and complete data supporting the need for rate decreases. That data should be fully explored in public informational hearings held by the Insurance Commissioner. At such hearings interested parties, including the leading insurance companies writing in the State, can discuss the auto insurance industry's profitability, the competitiveness of the Connecticut market and the question of why rates, and profit margins, have not dropped to levels which appear to be more reasonable that they are at present.

The difficult problem of the cost of automobile insurance in the cities must also be addressed. Urban residents with good driving records pay more for required automobile insurance coverage in Connecticut than do similarly classified drivers in the suburbs. The high urban auto insurance rates are particularly punishing when it is considered that the cities have higher concentrations of poor than do other, less urban municipalities.

There may be new ways to help city drivers without imposing new or higher costs on suburban consumers, without being unfair to insurance companies and without reducing access to auto insurance. The Report suggests several approaches that should be explored. Two of the primary suggestions involve:

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1. Basing auto insurance rates primarily on an individual's driving record and experience and less on a town where an individual lives. Using a ratemaking formula that maximizes the effect of driving record, such as the sequential analysis approach used in Califomia, could reduce price differences between territories, primarily benefiting good drivers, without sacrificing actuarial soundness.

3. Increasing consumer-buying power through use of aggregation, competitive bidding and group sales to city residents. This methodology is currently being discussed in electric utility deregulation efforts in Connecticut and group buying programs for auto insurance are currently being tried in Milwaukee and Baltimore.

4.There appears to be considerable room for cost savings for Connecticut auto insurance customers. Further, innovative insurance purchasing methods and ratemaking policies that reward good drivers may bring additional cost reductions and increase fairness in Connecticut's automobile insurance system. Better dissemination of price information should also help bring down excessive prices. The very recent placing of the price guide on the Intemet by the Connecticut Insurance Department is a good first step in this direction.

Overall Rate Level Indications

Exhibit 1 is a copy of relevant pages from the National Association of Insurance Commissioners' (NAIC) study, Report on Profitability By Line by State in 1996. As you see, the profit on net worth for private passenger auto insurance in Connecticut was 17.0% for 1996.[2] This is high, as most analysts would say that profits in the 10% to 15% range are sufficient for this line of insurance. State Farm, the nation's leading writer of auto insurance, for instance, makes this statement in its rate filings, "An expected total return in the 10% to 15% range is reasonable in comparison to the returns of other industries." (See Exhibit 2) In its recent filing in Connecticut, Nationwide used 10.6% as its needed total return in setting private passenger auto insurance prices.

Exhibit 3 shows the 1996 NAIC profit data for each state and countrywide. The first page of this exhibit is a ranking by state for profit. Please note that Connecticut has the fifth highest profit in the nation in 1996. Connecticut's return (which excludes unrealized capital gains) of 17.0% is 40.5% higher than the countrywide average return of 12. 1 %.[3]

However, there is a problem with the NAIC analysis. It is based on actual premium to surplus ratios and the industry is, as A. M. Best and others have said, "excessively capitalized."[4] This excessive capitalization is due to remarkable profits in recent years for the property/casualty insurance business.

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[2]Automobde Insurance in Massachusetts: Market Assessment, Center for Insurance Research, October 1997.

Because of overcapitalization, I undertook an analysis assuming $2 of premium for each $1 of surplus. The 2:1 ratio has been an industry standard for decades. The financial writer Roger Kenny first developed it in the 1960s. Insurance regulators have accepted the 2:1 test as a goal for property-casualty underwriters because it is both safe and economically efficient. Tests for solvency developed by the National Association of insurance Commissioners, the so-called IRIS[5] tests, kick in when this ratio exceeds 3: 1.

As a result of regulatory acceptance of this ratio, insurance companies use the 2: 1 premium to surplus ratio as a basis for their ratemaking. That level is currently used by State Farm in its ratemaking (although its actual premium to surplus ratio is 1.3 to 1).[6] Nationwide, in its 1998 Connecticut filing, also used 2: 1, calling it, "the desired premium to surplus ratio," albeit its actual ratio today is a remarkably low 0.8: 1.

Exhibit 4 shows the result of this analysis. The return on statutory net worth using a 2: 1 premium to surplus ratio to calculate the net worth for 1995 and 1996 for private passenger auto insurance in Connecticut was as follows:

	Incurred Basis[7]
LIABILITY - 1995	20.6%
PHYS. DGE. - 1995	30.40
TOTAL - 1995	23.70
LIABILITY - 1996	38.8%
PHYS. DGE. - 1996	23.90
TOTAL - 1996	33.9.

Data for 1997 are not yet available on an aggregated basis from the NAIC or other sources. However, the Connecticut Insurance Department was kind enough to supply us with the Annual Statement Information for the ten leading groups of insurers in the state. These insurance companies represent 62% of the state's private passenger auto insurance premiums.

A spreadsheet showing these data is attached as Exhibit 5. The return on net worth based on the actual premium to surplus ratio of 1. 1: I was 21.5% for private passenger auto insurance in Connecticut in 1997. Using the more reasonable 2: 1 leverage discussed above, the profit in 1997 was 39.0%.

By any measure, private passenger auto rates in Connecticut were too high in 1996 and 1997.

In order to determine if the insurance companies have already acted to lower prices to more reasonable levels, we requested the mte filings made by the largest premium writing five insurer groups (representing 41% of the market) since January 1, 1996. The Insurance Department supplied this information.

We also requested the percentage changes in 1998 for all 162 insurance companies writing auto insurance in Connecticut. There have been 33 mte changes so far in 1998, 19 reductions and 14 increases. The average change for these 33 companies is a reduction of 2.7%. But this represents a decrease for only 20% of the insurance companies writing auto insurance in Connecticut.
In order to estimate the effect on the entire Connecticut private passenger auto insurance market, we reviewed the changes so far in 1998 for the top ten insurer groups. There have been eight reductions effective in 1998 for the insurers that make up these ten leading groups writing private passenger auto insurance in Connecticut. They were: rate decreases of 5.5% for Nationwide Mutual Insurance Company, 4.7% for Nationwide Mutual Fire Insurance Company, 4.0% for Windsor Insurance of the Ameiican Financial Group, 2.9% for Hartford Fire Insurance, 5.2% for Hartford Insurance of the Midwest, 3.9% for Progressive Northwest, 1.7% for Uberty Mutual and 10.0% for Hartford A&I. American Financial Group's Atlanta Casualty Company had an increase of 6. 1 % and Metropolitan General had an increase of 1.2%.@@ The companies involved in rate changes this year represent about 30% of the premium of the top ten groups. While the average rate change for the companies listed above was a reduction of 4. 1%, the overall impact of the rate changes on the premium of the studied top ten groups is a reduction overall of 1.2% so far in 1998.

In other words, although some companies (33 of 162) have changed rates in 1998 on average by -2.7%, the overall effect of the rate changes on the entire market is only a reduction of 1.2%.

For earlier years, we did an in depth review of only the top five groups. In 1997, there were five increases and four decreases filed for companies in the top five groups. The effect of these changes on the overall five insurer group premium was a small increase of 0. 1%. It has been reported that the overall change in 1997 for private passenger auto insurance rates in Connecticut was a reduction of 0.2%"

In 1996, there were 7 increases and one decrease, with an overall rate effect on the top five groups of +1.35%.'

ANALYSIS OF CURRENT OVERALL RATE LEVELS

Profits in 1996 and 1997 were 17.0% and 21.5% based on actual leverage (i.e. premium to surplus ratios on the books of the Connecficut private passenger auto insurance market in the database). Using the average of these two years yields a two-year return on net worth of 19.3%. This means prices were 3.9% excessive during that time on this basis.i During 1997 alone, the prices were 5.9% excessive.@@

On the basis of the 2:1 premium to surplus leverage, profits in 1996 and 1997 were 33.9% and 39.0%. This implies an excess profit during the two-year period of 10.7%.@@
In 1997, on a 2:1 basis, profits were 12.0% excessive."'

In that trends are down in losses and insurer costs, the excesses of 1998 would be at least maintained throughout 1998, in my opinion. Given these assumptions, rates should fall by at least 5.9% in Connecticut. Indeed, if the recent trends in insurer costs of about a 2% to 3% reduction in costs continues, as I expect it will in the near tenn, rates should fall by at least 8% in Connecticut in 1998 for prices to assure non-excessive rates.

If instead of using a 15% return target, one selected the mid-point of the 10% to 15% reasonable profit range, rates could fall by 15% in 1998."

So far in 1998, rutes have fallen only by 1.2%, only one-fifth of the minimum indicated reduction.

Some important caveats must be raised. These conclusions have not been drawn from ratemaking data. Only individual insurer rate filings can determine with precision what rate changes are needed. All that can be said with certainty is that it is very likely that a significant overall rate reduction would occur if insurers filed rate changes now.

A review of the rate filings made in 1998 shows that the trends in loss costs and frequencies in Connecticut are downward on an overall basis currently so that the results should continue to improve during the near term. Since the trend in insurance costs is downward"', the current indicated rate reductions are likely to become bigger reductions as time passes if no rate action is taken.

INDIVIDUAL INSURER GROUP "INDICATIONS"

As the spreadsheet, Exhibit 5, shows, the prof-it margins vary widely company to company. This is why individual rate submissions are needed. Also, ratemaking data are different from financial data in that a complete adjustment is made for rate changes and for trends in costs and other known changes (such as law changes). The "indications" shown in this section are merely suggestions that rates are out of line, but this must be tested with ratemaking data supplied by the insurance companies.

Comparative 1996 and 1997 loss ratios (incurred losses/eamed premium)"fi for each of the ten top groups are:

RANK	GROUP	1997 CONN. LOSS RATIO	1997 NATL LOSS RATIO"@@	1996 NATL	LOSS RATIO"'
1	Allstate	48.6%	59.7%	63.7%	
2	Travelers	32.8	56.9	57.8	
3	Amer. Financial		62.9	64.6	67.9

4	Nationwide	61.7	64.2	67.3	
5	Berkshire Hath.		68.1	67.6	69.4
6	Hartford	64.3	66.1	71.5	
7	Metropolitan	47.3	63.0	65.7	
8	AMICA@@	55.6	56.1@@	59.7	
9	Progressive	61.6	58.5	60.4	
10	Liberty Mutual		50.9	67.9	65.6

Loss ratios are significantly better in Connecticut than nationally, as this table reveals. Connecticut in 1997 was an exceptional place for private passenger auto insurers to make money. In 1996, the national average loss ratio for all carriers was 66.6%. The loss ratio enjoyed in Connecticut was lower for each of the top ten insuring groups (except for Progressive) than that group's 1996 national average. The loss ratio in Connecticut was also lower for each of the top ten insuring groups (except for Berkshire Hathaway and Progressive) than that group's 1997 national average. On average the loss ratio for the top ten groups in Connecticut was 55.7% in 1997 compared to 64.9% countrywide in 1996 and 62.8% in 1997 for these ten groups.

Since a countrywide loss ratios of 67% in 1996 produced acceptable profit levels', and since total expenses run at about 33% for the insurance industry generally and below 25% for efficient insurers, loss ratios below 60% are very suspect in terms of either undue profits or very poor economic efficiency. Connecticut loss ratios confirm that rates are too high in the State.

Exhibit 5 implies that certain insurance companies should be examined to see if significant mte reductions are not indicated. Subject to verification by cuffent ratemaking data, mtes appear too high for at least these insurance companies in the top five groups:

COMPANY	ROUGH AMOUNT OF INDICATED RATE REDU-. io@@
Allstate Ins. Co.	10%-20%@@"
Phoenix Ins. Co.	25%-40%C
Travelers Indem.	30%-50%C
Travelers P/C	NC -10%C
Nationwide Mut.	NC-10%@@v
Govemment Employees	5%-10%C

The "C" after the indicated r-ate reduction for four of the above companies indicates a 44 credibility" issue is likely involved in this indication. Credibility is the degree of believability an actuary gives to a body of data. This will be considered in any rate submission made by these insurance companies.

Even the figures cited above which do not have a credibility issue to consider are not firm figures. The point here is simply that these insurers should be included in any in-depth review undertaken as a result of this report.

A review of the rate filings for the second ranked five insurer groups was not undertaken, although their experience is displayed in Exhibit 5. Instead, I studied their loss ratios to see if the probability that prices could be lowered was high in this group of insurers as well. Companies in this group with very low loss ratios include Hartford Casualty, Metropolitan P/C, Metropolitan Casualty, AMICA,@@ and Liberty Mutual Fire. These companies likely should be asked to attend the hearing to explain if rate reductions are indicated for them at this time as well.

RECOMMENDATION

Connecticut law states that "Rates shall not be excessive, inadequate or unfairly discriminatory" and that a "rate in a competitive market is not excessive."@@ The law goes on to presume that a competitive market exists.'@@

However, the law requires the Commissioner to "monitor" competition. "' In doing so, he can obtain documents through cooperation or subpoena and "make such public and private investigations within or outside this state as he deems necessary."

The Insurance Department should call a public hearing to seek information (or after seeking infon-nation) from at least the ten leading writers of private passenger auto insurance in Connecticut regarding the efficacy of competition vis-A-vis current rates. The hearing should be structured to obtain the insurers' comment on their cuffent rate level indications and anticipated rate action, if any (Since one of the key indicia of workable competition is the capacity of competition to "regulate" prices).' The seeking of information and explanations about the cuffent status of rates is not heavy-handed regulation; it is not regulation at all. It is merely good stewardship given the preliminary findings contained in this report and the questions this raises about competition.

One other step could help all Connecticut buyers of insurance. That is getting good comparafive price infon-nation into the hands of all Connecticut drivers. The Connecticut Insurance department has a price guide that contains rate comparison by territory.' Since this Report was initiated in April 1998, the Connecticut Insurance Department has updated this guide and put it on the Intemet.@@ This new development of putting the price guide on the Intemet is an excellent innovation and consumer service by the Connecticut Insurance Department.

The guides I reviewed show that rates vary widely within territories. A person could easily pay 100% more for identical coverage if that person did not shop wisely. The wide disparity of prices for identical drivers presents an opportunity for consumer shopping education, which could result in significant price savings in cities and all other territories. The buyers guide is helpful and could be distributed more widely through innovations such as putting a notice of its availability in driver license and registration notices. The guide should be aggressively promoted to the public, particularly now that it is on the Intemet.

One successful idea for publicizing the guide that was tried in Texas was this: the Insurance Department assembled a focus group of consumers to determine how much spending an hour calling for rate quotes based on the Texas guide could save the typical consumer. It was $118! So a press release was issued calling on consumers to try the guide: "This is the $100 hour, who pays you that much?" 75,000 requests for the guide were received in the first week.

Another idea is requiring insurance companies to submit computerized rate information in a standard format along with their rate filings to help information systems that are being privately developed. Price information specific to the consumer is being developed by private vendors, such as that currently available from Consumer's Union in Connecticut. The price for such information could be cut dramatically with computerized updates rather than labor-intensive data collection, analysis and input.

A further idea would be for the Insurance Department to send a flyer to all publicly accessible computer centers (such as schools and libraries) of the availability of the new Intemet price service.

Having better-informed consumers will greatly enhance competition and drive down prices throughout Connecticut.

URBAN INSURANCE RATES

- RATEMAKING APPROACH

Many states have wrestled with the dual problems of auto (and homeowners) insurance availability and affordability in cities. Auto insurance, being required by the state, is a sort of tax for driving. High cost in cities where many residents may be poor is seen as a regressive tax for people who often must drive at or to work. Nces between territories vary by more than 60% in Connecticut today. @@

A continuing problem in Connecticut, apparently, has been affordability in certain urban areas. This is not a new problem. In 1978, the City of Hartford sought a declaratory ruling from the Insurance Commissioner that "the present territorial system for charging rates for automobile... insurance, which system establishes the City of Hartford as a separate rating territory, is unfairly discriminatory." After hearings that went on for 24 days, Commissioner Mike found that no constitutional provision had been violated but determined that the territorial system did not meet the standards of the insurance law.@@'

The decision was implemented on December 15,1978 in Bulletin No. NF-54 which found that territory rates should not be based entirely on each territory's loss costs, but such indication should be moderated. Further, the Commissioner found it inappropriate to allocate general expense in proportion to territorial loss costs.

In 1993, the Legislature passed Pub. Act No. 93-297. Among other things, this Act required that the Insurance Commissioner study "the rating and premium impact of adjusting territorial rating formulas to reduce rates for consumers in high cost territories." Commissioner Googins issued a report, based on a study by the actuarial finn of Tillinghast, concluded that the system in place as a r-esult of the 1978 proceeding was adequate and required no change.

Subsequent to this report, the Commissioner published Bulletin No. PC-26 on February 24, 1994. This Bulletin requires that assigning 75% weight to individual territory indicated rates and 25% weight to the statewide-indicated rates moderate indicated private passenger auto rate changes by territory. This tempers the rate spread toward the average statewide rate, benefiting the city dwellers but raising prices in the more rural areas.

A review of the recent (1996 to date) rate filings of the top five insurer groups in Connecticut shows that the ratemaking approach used in Connecticut to allocate the overall rate need for the state to the territories is the same as that used by insurunce companies in most states in the Union. Three to five years of data are used to establish the indicated price differences (called "differentials") between the tenitolies. These indicated differentials are adjusted for credibility (i. e. believability) and are used to determine the territory's indicated price. In Connecticut, these prices are then adjusted for the 75%/25% tempering mentioned above.

Connecticut also has a degree of control on the territory definitions [i.e. "any change in territorial classifications shall be subject to prior approval by the Insurance Commissioner" - Sec. 38a-686(b)(3)]. There are 18 standard territories established in Connecticut. These territories were established by the Insurance Services Office (ISO), the leading rate bureau in the nation.' Each insur-er can amend these territories by making a filing with the Commissioner demonstrating the need to change the configuration ISO uses.

Other states use similar methods to moderate high prices in urban areas. Some, such as South Carolina, control the territory definition to keep territories relatively broad so that the surrounding suburbs and the inner city pay the same price. Others, such as New Jersey, simply cap the territorial prices to some relationship of the statewide rate. New York has used the practice of setting the assigned risk plan rates half way between the indicated assigned iisk plan price and the voluntary market price to deal with high prices in the cities.

Califomia adopted a new approach after the people of the state of Califomia passed Proposition 103 in 1988. Proposition 103 required that, in pricing of auto insurance, the greatest weight be given first to driving record, the second greatest weight to miles driven, the third greatest weight to years of driving experience and the fourth greatest weight to everything else, including tenitory.

The Califomia debate rages on as to what this means. What is agreed to is that it at least means that the first three factors must be given their largest possible "statistical" weight (i.e. that the analysis be done sequentially so that the maximum available variance be given to factor 1, then factor 2, etc). This rever-ses the sequence of analysis used by insurers elsewhere where territory gets analyzed first and effectively receives greater weight than it would if the sequence were reversed.

Sequential analysis is a methodology that ensures that the greatest importance is given to the rating factors in the order analyzed. Thus, sequential analysis proceeds one step at a time. The influence of prior rating factors is measured and eliminated so that the later factors being analyzed receive less of the impact they would have had they it had been measured with no such adjustment. For example, if driving record is analyzed before territory, good drivers in that territory are not forced to pay for the bad drivers in that territory. The key step is removing the variation or influence on loss costs accounted for by prior factors before determining the relativities for the rating factor next in the sequence.

For example, if a city has 50% more people with bad driving experience, that city's terfitory relativity will be considerably less if the influence of driving record is analyzed first and removed from the setting of the territorial relativity.

Consumer groups have argued that Proposition 103's weight requirement is stronger than this, meaning that the actual dollar impact on consumers must be most from factor 1, least from territory and the other items which make up factor 4.' For exarnple, if factor I has a weight of 12, factor 2 a weight of I I and factor 3 a weight of 10, factor 4 cannot be more than 9. Insurance companies strongly disagree with this interpretation, opting to end the weighting with the sequential analysis.

What is important for this discussion is that this sequential analysis is actuarially sound by anybody's standard and accepted by all parties in the Califomia debate as at least a step in bringing territory rates to more reasonable levels. Sequential analysis appears to reduce territorial rate impacts in Califomia to a degree. it is now required procedure in Califomia, as detailed in the Appendices to this report.'@@ How it might work in Connecticut is not known for sure, but I anticipate it would serve to moderate price differences between territories.

RECOMMENDATION

The Commissioner hold hearings on how territorial pfices are set, with a focus on ways to reduce disparities in prices while maintaining actuarial integrity. This hearing should be part of a broad took at territorial issues, including sales issues discussed in the next section of this Report.

Sequential analysis should be one of the items considered at this public hearing. Se'veral of the leading writers of auto insurance in Connecticut have several years of experience using this method in Califomia, and their experience could be explored. Since this method has some effect in reducing price differences between territories and is actuarially sound, it should be analyzed for possible implementation in Connecticut.

Review of other methods used in other states, such as broad territories and caps could also be part of the hearing. New ideas to cut cost for city dwellers via innovative sales techniques are discussed below and should also be part of the hearing.

At the hearing, consideration should be given to establishing a sen'es of meetings between city leaders and insurance executives. This might allow both the insurers and the city leaders to explore ideas on how to lower prices in the cities. Innovative concepts such as mini-policies (lower coverage options) for the poor, group sales to city residents, special companies set up to serve a city and other such ideas could be discussed.

When I was Insurance Commissioner of Texas, I convened such a sen'es of meetings in Houston. This resulted in a dialogue that helped address the most pressing need in Houston, availability problems in certain underserved sections of the city.

As to data needs, I would seek comparisons of cuffent prices by territory for major insurers. The Insurance Departrnent buyer's guide can be used as a base line from which alternative systems could be tested. For example, if insurers agree to cooperate, they could supply the impact of the sequential analysis on these rates, both with and without the current regulatory tempering.

- SELLING APPROACH

Different states have done different things to try to make insurance more affordable in cities. Some have required the filing of marketing plans; others have tried incentives such as fewer assigned risks being assigned if an insurer wrote more voluntarily in certain arm or zip codes in the cifies.

In Milwaukee, drivers who are members of churches that belong to the Milwaukee InnerCity Congregations Allied for Hope (MICAH@@') are saving up to hundreds of dollars on auto insurance. MICAH, through its auto insurance task force, studied territorial rating starting in 1995. Working with the Wisconsin insurance companies (through their Wisconsin Insurance Alliance), the task force obtained comparisons of rates by tenitory for major insurers. They found that different insurers used different territorial definitions but that the areas of the inner city had high auto insurance prices no matter what the definifion.

MICAH determined that the regulatory system in Wisconsin would not be the solution. So they sought out the insurance company offering the lowest prices in their area. This was Badger Mutual. Badger had its corporate offices in Milwaukee. MICAH and Badger entered into negotiations with MICAH holding the carrot of some 20,000 members in the churches it represented.

What resulted was this program: MICAH members could apply to Badger for insurance via a special application. If accepted, the member gets a 10% discount off of Badger's already lowest price. MICAH helps tell its members of the program, advises them that the applicant must qualify and educates the consumer about the details of the plan.

Since Badger still underwrites and accepts only what it considers to be "good" risks, this program is as good for the company as it is for its new customers.

In Baltimore, the Baltimore City's Community Association Buyers Group' established a similar partnership, this time with Progressive Insurance Company. Progress've has filed for a group rate for those members of the partnership. There are 5,500 members eligible. In order to be eligible, the applicant must be a member of an affiliated community association. The group rate will be discounted from the Progressive's nonnal rate.

The group is in negotiations with a possible second provider of these services: theTravelers Group, a Connecticut-based insurance group.

Group insurance is a tried and tested method for lowering cost through efficiency in delivcn'ng the product to the consumer. In health insurance, most Americans buy their coverage in this way. But in auto insurance, the insurance agents (who can make higher commissions selling auto insurance one at a time) have succeeded in getfing so-called "fictitious group" statutes in place in many states to thwart this efficient approach. In Connecticut, the relevant statute is Sec. 38a-827. This law prohibits the creation of a group rate except in limited circumstances such as common ownership. Therefore, it is difficult to take advantage of the efficiencies of group auto insurance sales in Connecticut today.

There are ways around this statute, such as forming a special company to write the group as Hwfford Insurance Group did for its AARP group auto policy. But this is a real obstacle that does thwart groups, particularly smaller groups, from forming,

I believe that the lack of a simple way to form groups for the purchase of auto insurance in Connecticut is very unfortunate. The group auto concept does produce lower prices. In Massachusetts, it is saving group members money as it does in the above, city-based groups.

Finally, the Balfimore City Counsel has done a feasibility study relative to the possibility of establishing a community based insurance company. A group called the City-Wide Coalition in Baltimore supported this idea. The study confirmed that this could work, but no funding has ever been approved to get this project off the ground.

RECOMMENDATION

The public hearing on urban insurance should study selling approaches that could save city residents money for auto insurance. The hearing could focus on such matters as:

Repeal of the fictitious group law (This may get strong insurance agent opposition, however, so working with key insurers and others who would benefit from this change is required to build the political base needed to repeal this law).

Creation of a Task Force of city leaders and insurance executives to study ways tobring down the high cost of auto insurance in Connecticut's cities.

The Task Force is a powerful tool since Hartford is the home of many large insurance companies which should have a vested interest in making insurance work well in that city. If ever there was a town where solutions to the problems could be achieved if effective leadership were provided, it is Hartford, in my opinion. Besides exploring the possibility of group approaches, mini-policies and other cover-age changes to bring down the costs, other ideas will be brought to the table by both sides.

' @@. Hunter is the Director of Insurance for Consumer Federation of America. He has served as Texas Insurance Commissioner (1993-1994), President of the National Insurance Consumer Organization (19801993), in various roles at dke Federal Insurance Administration, including Administrator tmder Presidents Ford and Carter, Deputy Administrator and Chief Ac@@ (1971-1980) and as an actuary in the private insurance sector (1960-1971). He is a Member of the American Academy of Actuaries (MAAA) and a Fellow, by examination, of the Casualty Actuarial Society (FCAS).
' 'Me use of total return on policyholder's swous or net worth has been a standard for measuring profitability in insurance for decades. A 1970 staff report of the NAIC concluded that, even if competition were deemed to control rates, states stdl had "a responsibility to ascertain the efficiency of competition ... and to intervene if competition fails." The report stated "In determining ... what constitutes a reasonable rate of rettim for the overall operation we believe that income from all sovrces shotdd be ascertained and considered." Net wordi is the difference between Assets and Liabilities on the insurance company balance sheet. On a statutory accotmting based balance sheet, it is called "policyholder surplus.
On a GAAP balance sheet it is called "net worth." In the 1984 NAIC Study of Investinent Income, fotmd in the Proceedings of the NAIC, 1984, Vol. II, die NAIC recommended that all mcome (inclu(hng underwriting, investment, realized and unrealized capital gains) should be considered and that "... net worth is the base upon which insurer profitability ran best be measured..."
For die three year period, 1994-1996, the Comecticut average prof-it was 14.3% compared widi die national average of 1 1.7%, 22% higher in Connecticut. ' The capital bacldng up the insurance business is called "policyholders' surplus." It is the difference between assets and liabilities on the insurance company's balance sheet. I use policyholder surplus as the indicator of capitalization in this report. Under statutory accounting, policyholders' sinplus is equal to net worth. Net worth under GAAP accounting is slightly different due to adding in such items as non-admitted assets into the fmal net worth figure.
' The Insurance RegWatory Information System ("IRIS') is used by the NAIC to give states early w ' 9 of possible solvency problems for an insurance company.
See Exbibit 2.
"Incurred basis" means based upon eamed premium and incurred losses. This is an accrual sort of ar-counting. It is best to be used for ratemaidng becausc it represents a cause and effect approach since eamed premium represents only the premium actually transferred to the insurer as time passes and incurred losses includes losses not yet paid (i.e. in reserve for future payout).

ResWts on a cash basis are interesting to see how much cash is flowing into the industry. These results are also included in Exhibit 2 for informational, not ratemaking, purposes.
@ Source: Rate filings
Comecticut Insurance Departinent, July 1, 1998.
Insurance Times, April 27, 1998, Page 3.
This is close to the reported increase of 1.96% (Source: National Association of insurance Commissioners, State Average Expenditures and Prendumsfor Personal Automobile Insurance in 1996, at Table 3).
(17.0% + 21.5%)/2--19.3%. 19.3 %- 15% (upper edge of range of reasonable profit)= 4.3% excessive.
Cuirent leverage is 1. I to I (NAIC). 4.3%/ 1. 1 =3.9% too high. We divide by the 1. 1: I leverage to convert

the excess profit on net worth to excess on premiums.
21.5% - 15% = 6.5% excessive. 6.5%/l.l = 5.9% too high.
(33.9% + 39.0%)/2 = 36.5. 36.5% - 15% = 21.5% 21.5%/2 = 10.7% too high.
39.0% - 15% = 24.0%. 24.0%/2 = 12.0% too high.
39.0% - 12.5% = 26.5%. 26.5%/2 = 13.3%. Factoring in an additima 2.0% for favorable trend gives a 15.0%indictedreductioiL [(I.O-.133)*.98]=O.850oral5%reduction.
' For instance, Cotmecticut's largest insurer, Allstate Insurance Company, had an ovemll three year
indicated trend in loss costs, aU coverages combined, of -6.4% in its rate filing dated April 28, 1997. In another recent filing by a large insurer, Nationwide Mumg's fihng dated January 26, 1998-, Nationwide selected an overau historic trend of -1.4%.
@ Loss ratios are the percentage of the premium which are incurred in losses. This is the largest part of the premium dollar and represents both losses paid out and the reserves held for future loss payments.
Source: A. M. Best Best's Review, P/C Edition, July 1998.
Source: A. M. Bests Averages and Averages, 1997 Edition.
Nationafly, ANUCA paid out a dividend to private passenger auto insureds of 13.8% in 1996 and 12.8% in 1997. In Connecticut in 19917 the ANUCA dividend to private passenger auto insurance policyholders

was 19.4%.
' 1997 data used for ANffCA in this chart from company page 14 of the 19917 Annual Statement. These

data were not in the Best's Review article cited above.
@ 12.1%onanactualleveragebasis,veryclosetothemid-pointoftherangeofreasonableprofits(10%

to 15%).
@ The method for maldng this rough estimate is as follows: Rate of Retum (Actual Leverage) minus 15% (top of range of fair retums) divided by the actual leverage ratio to convert the indication to a premium basis. For instance, for Allstate Insurance Company, the actual 1997 rate of return was 37.5%, less 15% 22.5% redundancy of profit on acnw leverage. The actual

leverage (premium to surplus) is 1.5 to 1. 22.5%/1.5 = 15.0% indicated reduction. The same sort of calculation on a 2: 1 basis produces a 17.5% reduction (50.0% - 15.0% = 35.0%/2 = 17.5%). 1 then rounded to produce a rough range around the

indication because of the imcertainties in this method.
Several of these companies (marked with a "C') have low credibility requiring credibility analysis as part of the ratemaldng ultimately applied.
@' AllstatelnsuranceCompanytookasmall(O.1%)ratereductioneffectiveonSeptemberlO,1997. According to AUstate, he indicated change was -4.0%. The filing reveals that Allstate signfficantly altered trend selections from the indicated trends, which had the effect of greatly understating the indicated

reduction.
' This indication includes the decrease already taken. A review of the Nationwide filing indicates that the ratemaking method understated the reduction by moderating downward trends and by ignoring any capital gains and by using an unwarranted "contingency factor". 'Me ratemaking data, in fact, support a furdier
reduction, in agreement with the financial data analyzed herein.
@ @@CA paid a substantial dividend to policyholders, however. It is not likely that a signfficant rate reduction is indicated for this company when the dividend is considered.
Com. Gen. Stat. Sec. 38a@@.
Com. Gen. Stat. Sec. 38a@@.
Ibid.
INd. Indeed, the Legislature, in deregulating rates said that among the purposes of doing so was to "promote sufficient consumer activity in the marketplace in order to generate a regwatory effect on price."

(Com. Gen. Stat. Sec. 38a-694).
' Connecticut Auto Insurance Price Guide. The version I received was dated 12/i/97.
' 'Me new guide includes rates as of June 11, 1998. The web page is www.state.ct.us/cid
Ibid.
Sec. 38a-665(a). This is the commercial insurance section of the statute. By analogy, the same would hold for personal risk insurance as well.
@ ISO can operate because federal anti-tmst laws are largely inoperative as respects insurance tmder the provisions of the McCaffan-Ferguson Act, Pubhc Law 15. ISO no longer sets fmal rates in most states, including Comecticut. However, ISO does adjust historic data for such things as trend into the future. If full anti-trust law applied, it is very doubtfw that ISO could undertake this effort on behalf of its member insurance companies.
' This mediod is known as the "Stewart Formida", named after Commissioner Richard Stewart who devised the approacb.
@ A copy of Califomia testimony by myself, representing consuner interests, and Nfichael NWIer, representing insurer interests, is attacbed as Appendix A.
' Attached as Appendix B are die Sequential Analysis Gutdelines for implementation of the required sequen0al analysis mder Califomia regulations Title 10, Section 2632.

@ NUCAH's telephone number is 41@@9-0805. The chair of the auto insurance task force is Rev. Demis Jacobsen.
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